

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105

NOTICE OF PROPOSED ACTION AND NOTICE OF PUBLIC HEARING

File No. RH04041245

Date: October 28, 2004

SUBJECT OF HEARING

Notice is hereby given that the Insurance Commissioner proposes to adopt the regulation described below after considering comments from the public. The Commissioner proposes to add to Title 10, California Code of Regulations, Chapter 5, Subchapter 3, Article 7.2, the new Section 2361 entitled: *Consideration of Losses and Loss Exposure in Residential Property Insurance Rating and Underwriting*. The regulation will implement guidelines for rating and underwriting residential property insurance.

The proposed regulation was also an emergency regulation which was most recently approved and July 12, 2004. This Notice is to begin the permanent rulemaking process.

AUTHORITY AND REFERENCE

The Commissioner proposes to adopt the proposed regulation under the express authority of California Insurance Code Section 790.10. These regulations are also authorized by Insurance Code Sections 679.71, 791.02, 791.10, 791.12, 1857, 1857.2, 1857.3, 1857.7, 1861.05 and 12926.

The proposed regulation will implement, interpret, and make specific California Insurance Code Sections 675, 676, 679.71, Article 6.5, 790. *et seq.*, 791.02, 791.10, 791.12, 1857, 1857.2, 1857.3, 1861.03, 1861.05 and 12926.

HEARING DATES AND LOCATIONS

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to this regulation on the following dates at the following locations.

**January 20, 2005 – 10:30 a.m.
California Department of Insurance Hearing Room
45 Fremont Street, 22nd Floor
San Francisco CA 94105**

PRESENTATION OF WRITTEN AND/OR ORAL COMMENTS: CONTACT PERSONS

All persons are invited to present oral and/or written comments at the scheduled hearing. Written comments not presented at the hearing must be addressed to the following contact person:

Donald Hilla, Senior Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4108

Questions regarding the hearing, comments or the substance of the proposed action should be addressed to the above contact person. If the contact person is unavailable, inquiries may be sent to the backup contact person:

Lara Sweat, Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4192

DEADLINE FOR WRITTEN COMMENTS

All written materials must be received by the Commissioner, care of the contact person at the address listed above, by no later than **5:00 p.m. on January 14, 2005**. Any materials received after that time will not be considered.

COMMENTS TRANSMITTED BY ELECTRONIC COMMUNICATION

The Commissioner will accept and strongly encourages written comments transmitted by e-mail, provided they are sent to the following e-mail address: hillad@insurance.ca.gov. The Commissioner also requests a hard copy of the comments electronically submitted. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of **Donald Hilla** using the following fax number: **(415) 904-5490**. **Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline for written comments set forth above.**

ACCESS TO HEARING ROOMS

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person for this hearing in order to make special arrangements, if necessary.

ADVOCACY OR WITNESS FEES

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of subchapter 4.5, title 10 of the California Code of Regulations, in connection with their

participation in this matter. Persons interested in inquiring about the appropriate procedures should contact the Office of the Public Advisor at the following address:

California Department of Insurance
Office of the Public Advisor
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking must also be submitted to the contact person for this hearing. Please contact the Office of the Public Advisor for further information.

INFORMATIVE DIGEST

Summary of Existing Law

CIC §675 defines residential property risks. The proposed regulation refers to this definition in defining the scope of the proposed regulation.

CIC §676 provides the legal requirements for a valid notice of cancellation and non-renewal of a residential property insurance policy. The proposed regulation refers to this definition in defining the scope of the proposed regulation and clarifies acts that may violate CIC §676.

CIC §679.71 provides an insurer may not refuse to issue a policy of residential property insurance under conditions less favorable to the potential insured than to other comparable potential insureds. The proposed regulation makes clear that loss history falls within the definition of “personal information” within the meaning of CIC 791.02 and that basing an adverse underwriting decision solely on information garnered from insurance-support organization databases may result in a violation of CIC §679.71.

CIC Article 6.5, §790 et seq. provides for regulation of trade practices in the business of insurance. These sections define prohibited acts and lists unfair and deceptive acts or practices. This regulation clarifies acts that may violate CIC §790 et seq. CIC §790.06 provides that under certain circumstances the Commissioner may define what constitutes an unfair insurance practice. The proposed regulation clarifies acts that may violate CIC §790 et seq.

CIC §790.10 provides that the commissioner shall promulgate reasonable rules and regulations to administer CIC §790 et seq. This section permits the Department to adopt regulations to interpret and make specific CIC §790 et seq.

CIC §791.02 is a comprehensive section that provides a number of definitions related to the subject matter of the proposed regulation. CIC §791.02(a)(1) defines the term “adverse underwriting decision” as the term is used in this regulation. CIC §791.02(s) defines the term “personal information.” The Commissioner has determined that that term includes historical loss information as well credit-related information. CIC §791.02(l) defines the term “insurance-

support organization” as it is used in this regulation. The proposed regulation, through the use of concrete examples, makes more specific this section.

CIC §791.10(a) provides the duties imposed on insurers when there is an adverse underwriting decision and CIC §791.12(b) provides that an insurer may not predicate an adverse underwriting decision on information gathered from an insurance-support organization unless it obtains “further personal information” from some source other than the insurance-support organization. The proposed regulation, through the use of concrete examples, makes more specific this section.

CIC §791.12(b) provides that an insurer may not predicate an adverse underwriting decision on information gathered from an insurance-support organization unless it obtains “further personal information” from some source other than the insurance-support organization. The proposed regulation, through the use of concrete examples, makes more specific this section.

CIC §1857(a) requires insurers to maintain reasonable records, of the type and kind reasonably adapted to its method of operation, of its experience, of the data, statistics, or information collected or used by it in connection with the rates, rating plans, rating systems and underwriting rules. The proposed regulation makes the records requirements in CIC §1857(a) more specific by detailing exactly the kind of records that must be kept in relation to compliance with the various insurance laws regarding rates, rating plans, rating systems and underwriting rules.

CIC §1857(i) provides specific authority for the Commissioner to promulgate regulations relating to record keeping.

CIC §1857.2 provides for additional examinations of the rates and rating systems of insurers. The proposed regulation makes the examination requirements in CIC §1857.2 more specific by detailing exactly the kind of records that must be kept in relation to compliance with the various insurance laws regarding rates, rating plans, rating systems and underwriting rules.

CIC §1857.3 provides who is subject to examination pursuant to CIC §1857 and what documents or records shall be examined. The proposed regulation makes the records requirements in CIC §1857.3 more specific by detailing exactly the kind of records that must be kept in relation to compliance with the various insurance laws regarding rates, rating plans, rating systems and underwriting rules.

CIC §1857.7 provides the contents of a rate change application. This section relates to underwriting for a number of reasons. Rates are numbers that are applied through underwriting. The assessment of risk in relation to the potential insured or the potential property to be insured is made by the gathering of information about the insured and the property to be insured. This information is applied, at least in part, through underwriting rules and guidelines. Failure to maintain underwriting guidelines that are sufficiently specific may result in an unfairly discriminatory rate (CCR §2360.2). Underwriting rules that may be sufficiently specific may nonetheless be applied in an unfairly discriminatory manner. The rate charged based on unfairly discriminatory underwriting would be an unfairly discriminatory rate. The proposed regulation, through the use of concrete examples, makes more specific this section of the CIC as it relates to residential property underwriting.

CIC §1861.03(a) provides that the business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act (Sections 51 to 53, inclusive, of the Civil Code), and the antitrust and unfair business practices laws (Parts 2 (commencing with Section 16600) and 3 (commencing with Section 17500) of Division 7 of the Business and Professions Code). This regulation, through the use of concrete examples, makes more specific this section.

CIC §1861.05(a) provides that no rate shall remain in effect that is excessive, inadequate, unfairly discriminatory or otherwise in violation of Chapter 9 of the Insurance Code. This section relates to underwriting as well as to rates for a number of reasons. Rates are numbers that are applied through underwriting. The assessment of risk in relation to the potential insured or the potential property to be insured is made by the gathering of information about the insured and the property to be insured. This information is then combined with underwriting rules and rating guidelines to arrive at the premium to be paid by the insured. This exercise is known as underwriting.

Eligibility guidelines are guidelines applied during the underwriting process. These guidelines are designed to screen potential applicants. This screening process necessarily has a direct effect on the pool of risks the insurer will be taking on, as such, these rules necessarily affect potential losses. The loss component in any ratemaking formula is a key component and one that has a profound effect on rates. The Commissioner clearly has jurisdiction over rules that have a profound, direct effect on rates.

Failure to maintain underwriting guidelines that are sufficiently specific may result in an unfairly discriminatory rate (CCR §2360.2). Underwriting rules that may be sufficiently specific may nonetheless be applied in an unfairly discriminatory manner. The rate charged based on unfairly discriminatory underwriting would be an unfairly discriminatory rate.

It is clear that the Commissioner has jurisdiction over rates as well as underwriting. This question was put to rest in *Wilson v. Fair Employment and Housing*, 46 Cal. App. 4th 1213, 1223; 54 Cal. Rptr. 2d 419, 424; (1996) where the court stated: . . .the Insurance Commissioner clearly possesses the expertise to evaluate and resolve issues regarding actuarial risks and allegedly discriminatory underwriting practices.

The Office of Administrative Law has also held that CIC §1861.05 prohibition against unfair discrimination extends to underwriting. In 2000 OAL Determination No. 15, the insurer requesting (the “requester”) the OAL determination argued that CIC §§1861.01 and 1861.05 applied only to rates and not to underwriting. The OAL Determination provides:

OAL disagrees with the requester that existing law, either statutory or regulatory, limits filing requirements to rates. For filing requirements that go beyond the filing of just “rates,” see Insurance Code section 1861.05(b) (“such other information as the commissioner may require”) and Title 10, CCR, sections 2643.3(b) (“require the filing of such other information as he or she deems

necessary to review the application and 2648.4(b) (“submission of relevant underwriting rules”).

Indeed, as the Office of Administrative Law pointed out, there are myriad examples in the current law where the Commissioner takes jurisdiction over underwriting as well as rates.

In *State Farm Mutual Automobile Insurance Company v. Garamendi* (32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343; 2004) the California Supreme Court made clear, once again, that the Commissioner’s authority under Proposition 103 is extremely broad. The court went on to note that the stated purpose of Proposition 103 is “‘to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.’ (Historical and Statutory Notes, 42A West’s Ann. Ins. Code (1993 ed.) foll. § 1861.01, p. 649.)” The Supreme Court also made it clear that Proposition 103 is “not only about rates and rate regulation; it also concerns other factors that may impermissibly affect the availability of insurance.” The subject of this hearing is a regulation that is designed and intended to protect California Insurance consumers and to ensure that residential property insurance is “fair, available and affordable for all Californians.”

The proposed regulation, through the use of concrete examples, makes more specific this section of the CIC as it relates to residential property underwriting.

CIC §1861.05(b) requires every insurer which desires to change any rate to file a complete rate application with the commissioner. A complete rate application shall include all data referred to in Insurance Code sections 1857.7, 1857.9 and 1864 and such other information as the commissioner may require. The proposed regulation, through the use of concrete examples, makes more specific this section.

CIC §12926 provides that the commissioner shall require compliance from every insurer with all the provisions of the CIC. This regulation, by clarifying residential property underwriting requirements, makes more specific this section of the CIC as it relates to residential property underwriting.

CCR §2348.4 requires the filing of underwriting eligibility guidelines. Cited as authority for this regulation is CIC §1861.05. The proposed regulation is similar in application yet narrower in scope as it applies to only residential property insurance.

CCR §2360.0 provides that eligibility guidelines are specific, objective factors, or categories of specific, objective factors, which are selected and/or defined by an insurer, and which have a substantial relationship to an insured’s loss. The proposed regulation, through the use of concrete examples, compliments this section.

CCR §2360.2 requires insurers to maintain eligibility guidelines for every line of insurance offered for sale to the public. The eligibility guidelines must be sufficiently detailed to determine the appropriate plan for the insured. The proposed regulation is similar in application yet more narrow in scope as it applies to only residential property insurance. This regulation, through the use of concrete examples, compliments this section.

CCR §2348.4 sets forth the requirement for a complete rate change application. Subsection (b) clearly refers to “underwriting rules.” The proposed regulation is similar in application yet more narrow in scope as it applies to only residential property insurance. This regulation, through the use of concrete examples, compliments this section.

POLICY STATEMENT OVERVIEW

A convergence of forces and unforeseen circumstances has come together in California to create a crisis in the residential property insurance market. The insurance industry, consumer protection groups, the press and the general public have all become aware of the situation.

While there are laws specific to insurance rating and underwriting that address cancellation, nonrenewal and eligibility for homeowners insurance, both the insurance industry and the insurance consuming public are unclear as to the exact application of these laws. This regulation is specifically designed to define, clarify and make specific the application of these laws in California.

The residential property insurance crisis centers around the cancellation and nonrenewal of existing homeowners coverage and a general lack of availability due to underwriting and eligibility guidelines applied by insurers that appear in many cases to be in noncompliance with the current insurance laws. The situation has been referred to in the press, and by the Commissioner, as “use it and lose it.” Under this scenario, even simple coverage inquiries have been used as the basis for cancellation and nonrenewal of insurance coverage.

The most visible evidence of this crisis is the number of media reports on the lack of availability of homeowners policies. The Commissioner has also been in communication with the real estate and financial industries and with various constituents who are being affected by this crisis.

A significant number of Californians have found it impossible to purchase residential property insurance or had their residential property insurance cancelled or nonrenewed due to acts that may be noncompliance with the California Insurance Code and California Code of Regulations. Many insurers in applying cancellation, nonrenewal and underwriting rules that are not clearly defined, or that rely solely on imperfect and inconsistent databases alone, have aggravated the insurance availability crisis in California.

Many of the problems in this area can be traced to the use of loss history databases compiled by various insurance-support organizations. Much of the data contained in these databases is imperfect and inconsistent, and reliance upon these imperfect and inconsistent databases may result in unfairly discriminatory treatment of policyholders and applicants. Even where the data in the databases is not flawed, current law in California requires that underwriting decisions not be based solely on the contents of the databases but only after further information is gathered from a source or sources other than that gathered from the insurance-support organization. Also, current law requires insurers to evaluate the risk of future loss in making any underwriting decision. The Commissioner believes that insurance industry reliance on these databases is exacerbating the availability crisis and that, if field exams can be used as a barometer, many

insurers are foregoing the required underwriting evaluations.

By defining certain terms and providing concrete examples this regulation is designed to clear up any ambiguity in this area of the insurance law. The Commissioner believes that until such time as this regulation is promulgated, the crisis will continue and insurers will continue to forego the underwriting evaluations currently required by law.

This regulation is intended to provide clear guidelines for the rating and underwriting of residential property insurance policies. Underwriting decisions take into account a number of factors which will vary from case to case. The Commissioner recognizes that it is impossible to anticipate every factor which will affect rating and underwriting. These regulations, therefore, do not attempt to impose a rigid, inflexible formula for residential property rating and underwriting.

The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other California Insurance Code provisions. The Commissioner believes proposing this regulation is necessary to ensure homeowners insurance remains available in California.

Effect of Proposed Action

The proposed regulation will implement, interpret and make specific several California Insurance Code sections in relation to residential property rating and underwriting. The proposed regulation will also provide clear, objective definitions and standards so that those subject to the regulation have a better understanding of what is required pursuant to the Code and Regulations. By providing a clear and consistent set of definitions, the proposed regulation will facilitate industry understanding of the terms and will prevent confusion and inconsistencies in residential property underwriting. The proposed regulation will also make clear how the various Insurance Code provisions interact with respect to residential property underwriting.

The criteria and guidelines proposed will also result in more effective residential property rating and underwriting by making clear that there is no justification for basing an adverse underwriting decision on losses or loss exposures which no longer exist because they bear no relationship to the risk of loss. Further, the proposed regulations make clear that mere inquiries cannot be used to form the basis of an adverse underwriting decision because inquiries bear no relationship to the future risk of loss. An inquiry about mold coverage does not cause the house to get toxic mold. Similarly, the proposed regulation also makes clear that an adverse underwriting decision must be based on exposure to loss, and therefore an insurer must gather sufficient information to make a reasonable determination about what the actual loss exposure is before using that loss exposure to rate the policy.

In summary, the effect of this proposed regulation will be to promote proper underwriting in the homeowners lines of insurance to bring an end to the availability crisis, as well as providing an objective way for the Department to verify compliance with the insurance laws.

MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS OR COSTS WHICH MUST BE REIMBURSED PURSUANT TO GOVERNMENT CODE SECTIONS 17500 THROUGH 17630

This proposed regulation does not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

COST OR SAVINGS TO ANY STATE AGENCY

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE WITH OTHER STATES

The Department has made an initial determination that adoption of the proposed regulation may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The types of businesses that may be affected are insurers and insurance underwriters. There will be additional record-keeping requirements imposed upon certain insurers that have not been previously required. The Commissioner has not considered proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

The types of businesses affected by the proposed regulations are insurers that transact residential property insurance in the State of California.

POTENTIAL COST IMPACT ON PRIVATE PERSONS OR BUSINESSES

The Department is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON JOBS IN CALIFORNIA

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of new businesses, and the expansion of businesses currently operating in the state. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above but invites interested parties to comment on this issue.

IMPACT ON HOUSING COSTS

The matters proposed herein will have no significant effect on housing costs.

ALTERNATIVES

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed action. The Commissioner, however, invites public comment on alternatives to the regulation.

Performance standards were considered. The objective identified was fairness in residential property underwriting. However, one of the reasons performance standards were rejected was that the criteria by which the attainment of this objective was to be evaluated would necessarily be impracticable, vague or otherwise ineffective given the abstract nature of the objective.

Performance standards were considered and rejected because it was decided that compliance with performance standards would be much more costly than compliance with prescriptive standards in the context of residential property underwriting. Prescriptive standards are more efficient in this context because, unlike performance standards, they provide the affected businesses a means of determining with certainty and exactitude whether or not they are in compliance, and if they are not, how to achieve compliance. Additionally it was felt that performance standards would foster costly litigation.

IMPACT ON SMALL BUSINESS

The matters proposed herein will only affect insurance companies, and therefore will not affect small business. (Gov. Code Section 11342.610, subd. (b), para. (2).)

COMPARABLE FEDERAL LAW

There are no existing federal regulations or statutes comparable to the proposed regulation.

TEXT OF REGULATIONS AND STATEMENT OF REASONS

The Commissioner has prepared an initial statement of reasons that sets forth the reasons for the proposed action. The Commissioner also has available all the information upon which this proposed action is based and the express terms of the proposed action. Upon request, the initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the statement of reasons, the information upon which the proposed action is based, and any supplemental information contained in the rulemaking file, is available for inspection and copying **by prior appointment** at 45 Fremont Street, 21st Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday. Written requests for the rulemaking file or questions regarding this proceeding should be directed to the contact persons listed above.

FINAL STATEMENT OF REASONS

Upon **written or e-mail** request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Written requests for the final statement of reasons should be directed to the contact person listed above.

AUTOMATIC MAILING

A copy of this notice, including the informative digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Commissioner's mailing list.

WEBSITE POSTINGS

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Near the bottom of the page, under "Select a Topic" click on "Consumers". Scroll down to the heading "Regulatory Activity." In this section, scroll down until you see the subheading "Proposed Regulations – Search." Click on the "Proposed Regulations-Search" link. When the "Search" screen appears, you may choose to find the documents by either conducting a search or by browsing for them by name.

To search, enter RH03031129 (the Department's regulation file number for these regulations) in the "Search for" field. Alternatively, search using as your search term the California Insurance Code number of a code section that the regulations implement (for instance, "1861.05"), or search by key words ("losses" for example). Then, click on the "Submit" button to display links to the various filing documents."

To browse, click on the "Browse All Regulations" button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear. Find in the list the "Losses and Loss Exposure" link, and click it. Links to the documents associated with these regulations will then be displayed.

AVAILABILITY OF MODIFIED TEXT OF REGULATION

If the regulations adopted by the Department differ from but are sufficiently related to the original text, the Department will make the modified text available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.

Dated: October 28, 2004

JOHN GARAMENDI
Insurance Commissioner

By: _____
Donald P. Hilla
Senior Staff Counsel